प्रेस प्रकाशनी PRESS RELEASE

भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

संचार विभाग, केंद्रीय कार्यालय, एस.बी.एस.मार्ग, मुंबई 400001

DEPARTMENT OF COMMUNICATION, Central Office, S.B.S. Marg, Mumbai 400001
फोन/Phone: 91 22 2266 0502 फैक्स/Fax: 91 22 2270 3279

वेबसाइट : www.rbi.org.in/hindi
Website : www.rbi.org.in
इ-मेल email: helpdoc@rbi.org.in

June 2, 2010

The Reserve Bank Staff Studies SS(DEAP): 2/2010 titled 'Monetary Policy Behaviour in India: Evidence from Taylor-Type Policy Frameworks'

The Reserve Bank of India today published its Staff Study SS (DEAP): 2/2010 entitled 'Monetary Policy Behaviour in India: Evidence from Taylor-Type Policy Frameworks'. The Staff Study, authored by Bhupal Singh, examines the response of monetary policy in India to inflation and output gap in the framework of Taylor rule.

Taylor rule, proposed by John B. Taylor in 1993, is a monetary-policy rule that specifies how much the central bank should change the nominal interest rate in response to divergences of actual inflation rates from the target inflation rates and of actual output from the potential output. A large part of the discussion of monetary policy on the Taylor rule relates to how the monetary policy should be conducted and how far the actual conduct of policy deviates from the rule-based parameters. The accommodative monetary policies globally after the recession of the early 2000s rates for too long has been in violation of the Taylor rule.

Contextually, the key motivation for this study is to understand the shifts in the relative weights that the monetary policy in India might have accorded to deviations in inflation and output – the key objectives of monetary policy. The study examines the interest rate path suggested by simple monetary policy rules in India. The relevance of such rules is that an analysis of what a rule-based monetary policy would suggest, can serve as a valuable guide for the exercise of discretion by the policy makers.

The reaction function has been estimated using ordinary least squares or instrumental variables in case of backward looking functions and using generalised method of moments in case of forward looking rules, as is the practice in standard empirical literature. In addition to the study also analyses monetary policy stance in India in a structural VAR model with output gap, inflation gap and policy interest rate. The structural VAR model has been used to calibrate the findings emerging from the static models.

A range of estimated models for Taylor rule in India in a historical perspective suggest that while the monetary policy appeared more responsive to the output gap than to the inflation gap during the period 1950-51 to 1987-88, there is a shift in policy response during the period 1988-89-2008-09 with relatively strong reaction to inflation gap than to the output gap. There is also evidence of more than proportional response of monetary policy to inflation gap in the latter period. The size of the coefficient of inflation gap has also increased significantly over time, which suggests a shift in the emphasis of monetary policy towards inflation concerns. An important difference in the interest rate smoothing behaviour of the central bank is a shift from large smoothing of short-term interest rates towards the rates recommended by Taylor rule in the earlier period to relatively gradual adjustment of short-term interest rates in the latter period. This is consistent with the measured actions of central bank given the uncertainties surrounding the economic environment and the transmission of policy rates. The estimates from a structural VAR framework also firmly establish that variations in the short-term interest rates are driven more by the inflation gap than the output gap.

G. Raghuraj
Deputy General Manager

Press Release : 2009-2010/1627